Financial Markets

Irving Trust

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Long-term rates are easing while short-term markets remain tight. Long-term markets, which reflect expectations about the future course of interest rates, are easing because of increasing evidence that a recession is here. The short-term markets, on the other hand, reflect the current supply and demand for credit, and the recession has clearly not yet taken hold sufficiently to ease credit demands.

The recession may already have begun, as declines are now visible in the coincident indicators. The composite coincident indicators compiled by the Commerce Department declined slightly in February. In March, employment, as measured by both the household and payroll surveys, also declined. Particularly significant was the 140,000 decline in the payroll figure.

Short-term interest rates have soared 500 basis points in less than two months, and analysts are trying to calculate the impact this unprecedentedly sharp increase will have on corporate profits. For many corporations, the direct effect will not be large relative to other factors because interest on debt represents a relatively small part of overall costs. On average, interest expense for all corporations accounts for only about 5% of total cost. Moreover, for many firms, a good portion of interest expense is at fixed rates and has, therefore, been unaffected by the recent increases. Many companies will experience the most significant impact of high interest rates indirectly, through slowing sales. High rates, for instance, have already contributed to the decline in residential construction, which is squeezing the profits of firms in the housing industry.

For financial corporations, on the other hand, interest expense accounts for a much higher percentage of their total cost--more than 50% for banks, thrifts, and finance companies. Profits for these institutions are, therefore, potentially more vulnerable than are those for businesses generally to the direct effect of a rise in interest rates. But the revenues of financial corporations also rise with rising interest rates, and this tends to offset the increase in their interest expense. Thus, a financial corporation's profits may either go up or down when interest rates increase; the key is the balance between its floating rate assets and floating rate liabilities, because only revenues and costs on these items are quickly affected by a change in interest rates. If the amount of floating rate assets exceeds the amount of floating rate liabilities, profits will tend to increase when interest rates rise. On the other hand, if floating rate liabilities exceed floating rate assets, profits will tend to decline when rates increase. The magnitude of this rate effect can be quite significant. Take a hypothetical situation in which floating rate liabilities exceed floating rate assets for an institution by an amount equal to 10% of its total assets. A 500 basis point rise in rates such as we have just experienced would translate into a 0.5% decline in before-tax earnings on total assets. The recent sharp rise in interest rates means that the rate factor will be an important component of the profit change registered by many financial corporations in the current environemnt. Some institutions will benefit and others will be hurt depending on their own individual balance between floating rate assets and liabilities.

Gordon B. Pye

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Market Yields

	4/4/80 (noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company			
Short-term loans to substantial depositors with highest credit rating	20.00%	19.50%	11.75%
Effective since	4/3/80		
Discount Rate at Federal Reserve Bank	13.00/16.00	13.00/16.00	9.50
Federal Funds	20.50	19.50	10.00
Repurchase Agreements	16.25	13.50	9.95
U.S. Treasury Issues			
Bills			
3 months	15.60	15.25	9.81
6 months	15.98	16.33	9.95
1 year	15.51	15.89	9.95
Coupons			
2 years	14.44	14.85	9.63
4 years	13.20	13.85	9.14
7 years	12.57	12.95	9.04
10 years	12.47	12.80	9.03
Long Bond	12.20	12.40	8.97
Negotiable Certificates of Deposit-Secondary Market			
1 month	17.50	17.25	10.00
3 months	18.00	18.15	10.10
6 months	18.30	18.45	10.30
1 year	N/A	17.25	10.45
Banker's Acceptances			
1 month	17.40	17.10	10.03
3 months	18.30	18.10	10.20
6 months	18.55	18.30	10.47
Eurodollar Deposits			
1 month	19.00	18.50	10.19
2 months	19.38	19.13	10.25
3 months	19.63	19.44	10.38
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	16.75	15.50	9.63
1 month	17.38	16.75	9.88
3 months	15.00	15.00	9.63
Bank Holding Companies			
1 month	17.50	16.50	9.75
Dealer Placed:			
3 months	17.00	17.25	10.00
New AA Corporate Utility Bond	15.25	14.25	9.80
Tax Exempt			
6 month Project Notes	8.60	8.75	5.15
1 year AAA Bond	8.00	8.00	N/A
5 year AAA Bond	8.10	8.10	N/A
20 year AAA Bond	9.44	9.10	5.80

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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